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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 194

ADELINE KIRSCHENMANN, PETITIONER

v.

HARRY C. WESTOVER, United States Collector of Internal Revenue for the Sixth District of California

---

HENRY KIRSCHENMANN, PETITIONER

v.

HARRY C. WESTOVER, United States Collector of Internal Revenue for the Sixth District of California

---

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the District Court (R. 70-72) and its findings of fact and conclusions of law (R. 73-81) are not yet reported. The opin-

ions of the Court of Appeals (R. 168-172; Pet. App. 1-5) are not yet reported.

JURISDICTION

The judgment of the Court of Appeals was entered March 8, 1955 (R. 173). A petition for rehearing filed by the taxpayers was denied May 31, 1955 (R. 174). The petition for a writ of certiorari was filed June 30, 1955. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTION PRESENTED

Taxpayers (husband and wife), lessees of land used in their business, contracted prior to expiration of the lease to purchase the land from the lessor, donated their interest in the purchase contract to their twelve year old daughter, and leased back the land from the daughter's guardian (taxpayer-husband's brother) at a rental many times in excess of that which they were obligated to pay under the pre-existing lease. The arrangement produced no change in taxpayers' use and control of the land, its purpose being tax avoidance.

The question is whether the court below erred in affirming the District Court's conclusion that the amount paid by taxpayers to their daughter's estate as "rent" was not deductible from their taxable incomes under Section 23(a)(1)(A) of the Internal Revenue Code of 1939.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * trades, businesses, * * * or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

[26 U.S.C. 1952 ed., Sec. 22.]

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [As amended by Section 121(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

[26 U.S.C. 1952 ed., Sec. 23.]

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

> Sec. 29.23(a)-1. *Business Expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business * * *. * * * Among the items included in business expenses are * * * rental for the use of business property. * * *

STATEMENT

Taxpayers are a husband and wife, who in 1944 filed their income tax returns on a community property basis. They each brought suit in the United States District Court for the Southern District of California seeking refund of income taxes paid following deficiency assessments for the year 1944. They claimed that the Commissioner of Internal Revenue had erroneously disallowed as a business expense deduction amounts paid in that year as "rent" to their minor daughter's guardian for the use of land which taxpayers in the same year had given to their daughter and had then leased back from her estate.[1] The District Court sustained the Commissioner (R. 70-72) and entered judgment for the Collector (R. 82-85). The Court of Appeals unanimously affirmed (R. 168-

[1] Originally taxpayers also sought an additional refund on an unrelated issue, which is not before this Court. This other issue was decided in the District Court in favor of the Collector (R. 70-71), and was disposed of in the court below by stipulation (R. 161-162, 171; Pet. App. 4).

171; Pet. App. 1-5), with one judge filing a brief concurring opinion (R. 171-172; Pet. App. 5).

The facts found by the District Court (R. 73-80) may be summarized as follows:[2]

In 1944 and prior thereto taxpayer-husband carried on a potato farming business in California. Part of the land used for that purpose was leased from one Margaret P. Osborne, under a five-year lease which was to expire October 31, 1946. The total rental under this lease was $4,550, of which $700 was payable for each of the first two years, and $1,050 for each remaining year. (R. 75.)

In August, 1943, about three years before the expiration of the lease, taxpayers agreed to purchase the land from Mrs. Osborne for a down payment of $8,000 and a like amount payable in each of the following three years. In January, 1944, taxpayers made a gift of their interest in the land to their daughter, age twelve, and the following month taxpayer-husband's brother was appointed guardian of the daughter's estate by the California Superior Court. Two weeks later the guardian leased the property back to taxpayer-husband for a five-year term, commencing July 1, 1944, on a share-crop basis. The lease and rental were in conformity with share-crop leases then in general use in the locality. In the fall of 1944, taxpayers paid to their daughter's estate $19,412.54 as

[2] The evidence consists principally of stipulations of fact (R. 30-35) and exhibits (R. 35-70). Taxpayers also offered oral testimony (R. 94-156).

"rental" for that year. (R. 75-77.) A similar gift-guardianship-leaseback arrangement was made with respect to land owned by the guardian-brother for the benefit of his minor children, taxpayer-husband being appointed their guardian (R. 77).

The balance of the price ($24,000) due under the purchase agreement between taxpayers and Mrs. Osborne was paid out of the daughter's estate over the following two-year period. Upon completion of the payments quit claim deeds were delivered by Mrs. Osborne's heirs (she had since died) to taxpayers. (R. 77-78.)

After the gift to their daughter and appointment of taxpayer-husband's brother as her guardian, taxpayers continued to exercise the same exclusive control over the land as before (R. 78). The rental arrangement between taxpayers and their daughter's estate was expressly found to have been "not entered into * * * in good faith and for a business purpose, but as a tax avoidance device" (R. 79).

Taxpayers deducted from their community business income for the year 1944 the $19,412.54 paid to their daughter's estate as "rental" for that year. When the Commissioner disallowed the deduction, taxpayers paid the resulting deficiencies, and brought suits for refund, which were consolidated for trial and for appeal.

Deciding that taxpayers "in reality retained control of the property", the District Court held that the "arrangement was not necessary or made

for the purpose of carrying on" taxpayers' potato farming business, and that taxpayers had in fact "retained an interest or equity" in the property which they had purportedly rented from their daughter's estate (R. 71, 80). The court also concluded "that the amount deducted was greater than could be considered as ordinary and necessary expense in conducting" taxpayers' farming business (R. 72).

In affirming, the Court of Appeals specifically noted that not only was there no finding that the so-called rent paid was reasonable, but that such a finding could not have found support in the record (R. 170; Pet. App. 4). That court also stated (R. 170-171, Pet. App. 4):

> Taxpayers by the terms of their lease with Mrs. Osborne were obligated to pay only $1050 for the year in question; instead, by their own contrivance, they elected to pay $19,412.54. To say in this situation that such disparity was not the result of a studied attempt to gain a tax advantage would indicate a blindness to reality. It is true, taxpayers divested themselves of title to the propery, yet they farmed the land as before, and in effect it was their earning power which formed the basis for the entire transaction, including payment of the purchase price. Tax consequences are determined not from the formal aspect of a transaction, but from the actual substance of a piece of business. What is found here lacks business meaning for tax purposes.

ARGUMENT

Contrary to taxpayers' argument (Pet. 8-15), the decision below is correct and involves no conflict of decisions or questions requiring settlement by this Court.

The case poses the now familiar question of whether an intra-family gift and leaseback arrangement, resulting in a reallocation of the donor's income within the family group, is to be accorded federal income tax effect. The same question was presented in *White* v. *Fitzpatrick,* 193 F. 2d 398 (C.A. 2d), certiorari denied, 343 U.S. 928, involving a similar arrangement, and the decision below is fully in accord with the decision in that case. Nothing has occurred since the denial of certiorari in the *White* case which would appear to warrant the granting of certiorari in this case, and there is no more occasion for further review of this case than of that one. Indeed, taxpayers here take essentially the same position, and rely for conflict upon the same decisions, *Skemp* v. *Commissioner,* 168 F. 2d 598 (C.A. 7th), and *Brown* v. *Commissioner,* 180 F. 2d 926 (C.A. 3d), certiorari denied, 340 U.S. 814, as did the taxpayer in the *White* case.

1. Section 22(a) of the Internal Revenue Code of 1939, *supra,* p. 3, broadly defines gross income as including income derived from a business, or from any other source whatever. Section 23(a)(1)(A), *supra,* p. 3, authorizes a deduction from gross income of "ordinary and neces-

sary" business expenses, including rental payments required to be made as a condition to the continued use or possession of business property. That an expense is contractually incurred does not render the payment of it deductible; the "origin and nature" of the liability out of which the expense accrues, not its legal form, determines the right to the deduction. *Interstate Transit Lines* v. *Commissioner*, 319 U.S. 590, 594; *Deputy* v. *duPont*, 308 U.S. 488, 494-496. [3] This rule is rooted in the fundamental principle that taxation is an intensely practical process, concerned with economic realities rather than legal formalities. [4] Where as here we are dealing with an intra-family transfer, the transaction is subject to special scrutiny lest what is in reality the income of one member of the family be disguised as that of another. [5] These prin-

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[3] In the *Interstate Transit Lines* case this Court stated (p. 594) that—

> The mere fact that the expense was incurred under contractual obligation does not of course make it the equivalent of a rightful deduction under § 23(a). * * * The origin and nature, and not the legal form, of the expense sought to be deducted determines the applicability of the words of §23(a).

[4] *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *Higgins* v. *Smith*, 308 U.S. 473; *Griffiths* v. *Commissioner*, 308 U.S. 355; *Gregory* v. *Helvering*, 293 U.S. 465.

[5] *Helvering* v. *Clifford*, 309 U.S. 331; *Helvering* v. *Stuart*, 317 U.S. 154; *Harrison* v. *Schaffner*, 312 U.S. 579; *Douglas* v. *Willcuts*, 296 U.S. 1; *Corliss* v. *Bowers*, 281 U.S. 376; *Burnet* v. *Wells*, 289 U.S. 670; *Commissioner* v. *Sunnen*, 333 U.S. 591; *Commissioner* v. *Tower*, 327 U.S. 280; *Commissioner* v. *Culbertson*, 337 U.S. 733.

ciples have been applied by the Courts of Appeals in a variety of contexts, including cases involving claimed business expense deductions.[6]

2. In this case, taxpayers seek to deduct from their community business income, and to treat as the income of their minor daughter, an amount paid to the daughter's estate as "rental" for property used in their business. They claim the deduction by virtue of a gift of the property to the daughter, appointment of taxpayer-husband's brother as guardian of the daughter, and a substantially contemporaneous leaseback of the property. The claim must fail for two reasons: (a) the arrangement amounted in substance to an assignment to the daughter of a portion of taxpayers' business income; and (b) the so-called rental payments do not in any event qualify for deduction under Section 23(a)(1)(A).

(a). In harmony with the rule that tax consequences flow from the substance rather than the form of a transaction, it is well settled that a transfer of legal title to income-producing pro-

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[6] See *White* v. *Fitzpatrick*, *supra*, p. 8, and cases there cited. Similarly, business expense deductions have been denied for payments which were labeled as rent or as other expenses or deductible items but were in reality dividend distributions. See *Stanwick's, Inc.* v. *Commissioner*, 190 F. 2d 84 (C.A. 4th); *W. H. Armston Co.* v. *Commissioner*, 188 F. 2d 531 (C.A. 5th); *Ingle Coal Corp.* v. *Commissioner*, 174 F. 2d 569 (C.A. 7th); *Limericks, Inc.* v. *Commissioner*, 165 F. 2d 483 (C.A. 5th); *Paramount-Richards Th.* v. *Commissioner*, 153 F. 2d 602, 604 (C.A. 5th); *Regensburg* v. *Commissioner*, 144 F. 2d 41 (C.A. 2d), certiorari denied, 323 U.S. 783; *Illinois Agricultural Hold. Co.* v. *Commissioner*, 131 F. 2d 583 (C.A. 7th).

perty does not suffice to insulate the transferor from tax liability, even though the income is paid over to the transferee, if the transferor remains the substantial owner of the property. Such a transfer is in substance and effect merely an assignment of the income. *Commissioner* v. *Sunnen,* 333 U.S. 591; *Helvering* v. *Clifford,* 309 U.S. 331; *Harrison* v. *Schaffner,* 312 U.S. 579; *Commissioner* v. *Tower,* 327 U.S. 280; *Commissioner* v. *Culbertson,* 337 U.S. 733. It is equally settled that retention of control over the property is tantamount to retention of substantial ownership, and it is an important factor, in determining whether the transferor has retained sufficient control to warrant treating him as the real owner for tax purposes, that the parties are closely related. *Helvering* v. *Clifford, supra; Commissioner* v. *Sunnen, supra,* p. 605. Accordingly, if the instant gift-leaseback arrangement did not divest taxpayers of actual command over the donated property, the arrangement amounted to nothing more than an assignment of income to the daughter in the guise of rental payments, and the payments are not deductible from taxpayers' incomes.

As is plain from its opinion, the court below properly applied these principles to the facts of this case. The District Court found (R. 71-72, 79) that taxpayers continued to enjoy the same control over the property after the gift and leaseback as before; that the arrangement was not entered into in good faith and for a business purpose, but to avoid tax; and that the "rental" paid

to the daughter's estate constituted a part of the income earned by taxpayers in their farming business.[7] On the basis of these facts the court below correctly affirmed the District Court's disallowance of the claimed rent deduction. When the transaction is viewed from beginning to end, as it must be, the conclusion is inescapable that its only practical effect was to shift to the daughter a portion of taxpayers' income, while leaving intact their effective control over the donated property. The court below aptly observed that while "taxpayers divested themselves of title to the property, yet they farmed the land as before, and in effect it was their earning power which formed the basis for the entire transaction" (R. 170; Pet. App. 4). Cf. *White* v. *Fitzpatrick*, 193 F. 2d 398 (C.A. 2d), certiorari denied, 343 U.S. 928; *W. H. Armston Co.* v. *Commissioner*, 188 F. 2d 531 (C.A. 5th); *Shaffer Terminals, Inc.* v. *Commissioner*, 16 T.C. 356, affirmed, 194 F. 2d 539 (C.A. 9th); *Ingle Coal Corp.* v. *Commissioner*, 174 F. 2d 569 (C.A. 7th).

(b). In any event, even assuming (contrary to

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[7] Taxpayers' contention (Pet. 12) that the gift was "unconditional and unfettered" rests upon general self-serving assertions by their attorney (R. 126-128). Significantly, taxpayer-husband's brother was appointed guardian of the donee-daughter, and the brother made a reciprocal arrangement for the benefit of his own minor children with taxpayer-husband as guardian (R. 77)—a feature which lends support to the finding that taxpayers did not relinquish dominion over the property and that "the purported gifts and reciprocal guardianships were employed to conceal the retention of [taxpayers'] control of the land in question" (R. 79).

the District Court's findings) that taxpayers parted with substantial ownership of the property, the so-called rental payments to the donee-daughter under the leaseback agreement still would not qualify for deduction under Section 23(a)(1)(A). The provisions of that section must of course be examined in the light of the "now familiar rule that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer". *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 593. See also *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440; *Deputy* v. *du Pont,* 308 U.S. 488, 493; *Commissioner* v. *Jacobson,* 336 U.S. 28, 48-49; *McDonald* v. *Commissioner,* 323 U.S. 57, 60.

To qualify for deduction under Section 23(a) the rental payment in question must have been an "ordinary and necessary" expense of carrying on taxpayers' farming business during the taxable year, and taxpayers must have been "required" to make them "as a condition to the continued use or possession" of the property. These statutory conditions clearly have not been met in this case. Taxpayers could have continued to use the land throughout the taxable year (1944) at a rental which was but a fraction of the amount paid to the daughter as rental, simply by continuing as lessees under the then existing Osborne lease. The District Court found (R. 75-79), and it is undisputed, that taxpayers were in possession of the property under a five-year lease from Mrs.

Osborne which would not terminate until the fall of 1946; that the rental for 1944 was $1,050; that in August of 1943 taxpayer contracted to purchase the property from Mrs. Osborne for a down payment of $8,000 and a like amount payable in each of the three subsequent years; that at the beginning of 1944 taxpayers gratuitously conveyed their interest in the purchase contract to their daughter; that two weeks later the daughter's guardian (taxpayer-husband's brother) leased the property back under a share-crop agreement pursuant to which taxpayers paid $19,412 to the daughter's estate as rental for 1944;[8] and that the balance of the price due under the purchase contract was paid by the daughter's estate out of the so-called rental payments received from taxpayers.

In the light of these facts the District Court was unquestionably justified in concluding that the expense was not an "ordinary and necessary" one (R. 71-72, 78-79), and the court below correctly affirmed its decision on that ground. The expense was neither "ordinary" nor "necessary",

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[8] Taxpayers seek comfort (Pet. 13) in the District Court's finding (R. 76) that the rental provided in the new lease was in conformity with share-crop leases in general use in the same locale. However, taxpayers ignore the critical fact, also found by the District Court (R. 71-72, 78-79), and properly stressed by the court below (R. 170; Pet. App. 4), that taxpayers were required to pay a rental of only $1,050 under the Osborne lease in order to continue in possession during 1944, yet undertook by the gift-leaseback arrangement to pay $19,412 to their daughter instead. As the court below noted, there is no finding here that the latter amount was reasonable, "nor could such conclusion find support on the record". (R. 170; Pet. App. 4).

since taxpayers already had the right to use the property throughout the taxable year without paying any more for its use than the amount they had contracted to pay to the original lessor. Looking through form to substance, the only result of the transaction was to increase almost twenty-fold the rental which taxpayers were obliged to pay, but to make the increased amount payable to a member of the family instead of to a stranger. In the words of the court below (R. 170; Pet. App. 4), "Taxpayers by the terms of their lease with Mrs. Osborne were obligated to pay only $1,050 for the year in question; instead, by their own contrivance, they elected to pay $19,412.54." Moreover, as pointed out in the concurring opinion below (R. 171; Pet. App. 5), taxpayers failed to meet the additional requirement of Section 23(a)(1)(A) that the rental be paid for "property to which the taxpayer has not taken or is not taking title or in which he has no equity".

3. The decision below is not in conflict with any decision of this Court or of any of the Courts of Appeals. Taxpayers assert conflict with *Skemp* v. *Commissioner*, 168 F. 2d 598 (C.A. 7th), and *Brown* v. *Commissioner*, 180 F. 2d 926 (C.A. 3d), certiorari denied, 340 U.S. 814. Although those cases appear to have been incorrectly decided and have been properly criticized,[9] in any event they

[9] In distinguishing the *Skemp* and *Brown* cases, the Second Circuit stated in *White* v. *Fitzpatrick*, 193 F. 2d at 401:

> These cases, which are criticized in reasoned discussions in 51 Col. L. Rev. 247 and 59 Yale L. J. 1529, may be thought to go to the verge of the law in support of what are essentially intrafamily transfers.

are clearly distinguishable on their facts for the reasons specifically pointed out by the court below (R. 170; Pet. App. 3-4).

In both the *Skemp* and *Brown* cases the gifts were made to independent trustees, the donor-taxpayer retained no control over the property, and the rent charged by the trustee was reasonable. No such situation is here presented. Here the arrangement was made with taxpayer-husband's brother as guardian of the donee-daughter; taxpayers in fact retained control over the property; and the rent charged was far in excess of the amount they were required to pay under the preexisting lease which still had several years to run. When a comparison is made between this case and others, it becomes evident that its factual resemblance is distinctly closer to the *White* case than to either *Skemp* or *Brown,* for the same reasons that these latter two cases were specifically distinguished in *White* (see 193 F. 2d at 401). Indeed, the very court which decided the *Skemp* case later distinguished it in *Ingle Coal Corp* v. *Commissioner,* 174 F. 2d 569, 572, on the grounds that in *Skemp* the taxpayer transferred the property "to an independent trustee-bank, retaining no control", and that consequently "there was a change in the taxpayer's economic status".

In this case both courts below concluded that the gift and leaseback produced no substantial change in taxpayers' control and economic status. Their concurrent findings should not be disturbed. "A seasoned and wise rule of this Court makes con-

current findings of two courts below final here in the absence of very exceptional showing of error." *Comstock* v. *Group of Investors,* 335 U.S. 211, 214.

CONCLUSION

The decision below is correct. There is no conflict, and no occasion for further review. The petition for a writ of certiorari should be denied.

Respectfully submitted.

SIMON E. SOBELOFF,
Solicitor General.
H. BRIAN HOLLAND,
Assistant Attorney General.
ELLIS N. SLACK,
HARRY BAUM,
Attorneys.

JULY, 1955.

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